



When compliance with a standard gets too expensive

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..... The theme of this issue being Enter- and Edutainment, I'm going to tell you a story about playing the entertaining game of mumblety peg in accordance with the Mumblety Peg Standard. That's not the real name of this standard, but all names are changed here to protect the guilty.

The Mumblety Peg Standard embodies patented technology, as the original standard setters intended. They were two manufacturers of mumblety peg apparatus and media, as well as suppliers of content for the media (for particular types of mumblety peg games). Their plan was to ensure that the standard for playing mumblety peg

would be based on their technology.

They ran into a little problem, however, because of a conflict between what media were best for their type of mumblety peg game and for the type marketed by another industry group. This group consisted of content providers of different types of mumblety peg games with significantly different technical requirements. The original two standard setters sought to impose a standard that optimized for their type of mumblety peg game. However, their standard system was functionally suboptimal (indeed, unsatisfactory) for the second group's type (among other things, too few Gbytes

of information storage). Since the standard setters' patents covered all mumblety peg media, they thought they could do as they pleased.

The second group complained to the US Federal Trade Commission and the Justice Department about the patent pool, resulting in an antitrust investigation. This group also threatened private antitrust suits and lobbied Congress. This resulted in a compromise on the technical requirements for the standard, at least for a time.

The original standard setters then applied for a clearance from the Justice Department—a so-called business review letter. Under this review procedure, the government advises a business applicant in a public document that certain procedures will satisfy the government antitrust officials' concerns sufficiently that they will agree not to sue the applicant in the foreseeable future. In this case, it also led to the government's discontinuing its antitrust investigation. (The latter was unusual.)

According to Justice's clearance letter, the government gave its blessing to the patent pool for several reasons. First, the establishment of a Mumblety Peg Standard was considered procompetitive in itself. The public benefits from standards because they promote early adoption of technological innovations. Conversely, technological innovation may slow if a standards battle erupts, as occurred with Betamax versus VHS sometime ago.

The government considered the mumblety peg patent pool essential to the



establishment of the standard. Users of the standard would be prevented from following the standard if they could not get licenses under all of the patents embodied in the core of the standard. (Some bells and whistles, enhancements, or extensions may be optional.) A pool's "one-stop shopping" transactional efficiencies facilitate users' acquisition of a comprehensive license and thus lessen their administrative costs in using the standard.

Moreover, its benefits and the conditions proposed (or acquiesced in) by the applicants for the clearance neutralized the potential anticompetitive effects of the patent pool (price fixing, boycotts, and monopolization). The pool pledged that any applicant would receive a license from the pool on nondiscriminatory terms. The proposed royalty rate of less than 4% was low enough not to create a barrier to entry into the business of supplying mumblety peg apparatus and media.

Finally, joining the licensing pool would be open to anyone owning patents on technology essential to the use of the standard. An independent technical guru would determine this fact. Owners of essential patents would contribute the use of their essential patents to the pool. (The same independent mumblety peg guru would determine point values for the different patents contributed to the pool, and contributors would share in net revenue from third parties in proportion to their points.) The sum total of these pledges made the pool a useful instrument in establishing the standard and permitting its broad and efficient use without harming competition.

Difficulties

The peace treaty between the original standard setters and the rest of the industry (mainly, the second group) soon began to fall apart. A major point of difference was that mumblety peg content providers did not need, or want to pay for, licenses under any patented apparatus for playing mumblety peg or apparatus for manufacturing unencoded media. They needed licenses only on the media as such and

Mumblety Peg

Played with a knife, Mumblety Peg is a variant of "Follow The Leader." The basic form of the game requires any kind of a knife and two or more players. The object of the exercise is to get the knife to stick in the ground by having it fall or be flipped or tossed or dropped from various parts of each person. The first person to play may balance the tip of the knife blade on his index finger, for instance, and let it fall off the end of his finger toward the ground. If he makes it stick, every player following him must do the same. Each person scores a point for accomplishing the feat. Should he miss, then the next person has the discretion of choosing how and from where the knife is dropped, thrown, or flipped toward the ground. The game usually continues until the players are bored with the futility of the exercise.

<http://www.geocities.com/Heartland/Woods/3501/19th.htm>

on the method and apparatus for encoding the media.

Another point of dispute was that the various patents respectively involved several different technologies—dependent on what kind of game would be involved, such as long ones and short ones. To some extent, that applied to the media as well, which were similarly differentiated in technology (many Gbytes versus few Gbytes). This original difference in outlook between the first and second industry groups had led to the antitrust investigation that preceded the business review and clearance.

The upshot was a splitting of patent pools: One pool of patents on media and encoding them, and another pool of patents on apparatus for playing. (This is an oversimplification. There was some cross-over.)

Each pool now charged a separate patent royalty of several percent. That was tolerable for those using only one or the other set of pooled patents, but it irked those few that needed both sets. They said two times 4% (say, almost 8%) is too much in their industry, even though one times 4% is tolerable. Also, it turned out that sellers of unencoded media had more of a problem with royalty cost than did sellers of encoded media. The latter, being content providers and thus part of "show biz," traditionally enjoyed much higher unit margins than hardware manufacturers. They were less concerned over a mere several percent.

Finally, some newcomers began to complain that the royalty was too much

and discriminated against them. Say that a newcomer has preexisting cross-licenses with several members of the apparatus pool (common, for example, in the electronics industry). The newcomer also has some technology, but the pool's guru says that this technology is not essential to the standard. In fact, the standard was set before the newcomer's technology came on the market. Therefore, it is not part of the standard. At best, it is an inessential enhancement. Therefore, they could not get status as a pool member.

The newcomers wanted credit for their preexisting cross-licenses covering some, but not all, of the pooled patents. This involves a curious fact about licensing patents on a standard. Say that ten patents are needed to practice the core of the standard. The tenth patent licensed, whichever it is, can command by far the highest royalty, because any one patent essential to practicing the standard can block use of all the others.

Say this is the fact pattern: you already have royalty-free cross-licenses or paid-up licenses on nine of the pooled patents. The customary royalty rates on the nine patents add up to 4.5%, the going rate being 0.5% for each. The traffic will bear only 5% on the product that the pooled patents cover. You assert that you want a license on the tenth patent for 0.5% or at most 1%. The pool manager says the pool licenses only the whole pool of patents at 5%. The pool does not care how many patents you actually want. In fact, the pool's letter applying for business review clearance stated that "the policy of the

pool is that when we act as a pool, there is a single price for the pooled patents—if you use one or all of the pooled patents, you pay the same 4%.” The pool presented this point to the government as part of the pool’s pledge that it would not discriminate against anybody.

You argue that the pool is discriminating against you, by charging ten times the fair market value of the one patent you want—that being the effect of the pool’s compulsory package license. The pool manager replies that the pool would discriminate against everybody else if it gave you a license for a tenth of what every other applicant for a license must pay. You then go to the owner of the tenth patent and ask for a license at 0.5%. The patent owner politely declines to be bothered and suggests that you contact the pool’s manager for a pool license. Or else, the patent owner offers you a license at 4%. Either way, you don’t get a better deal on licensing only the last patent.

Since you cannot practice the standard without licenses under all core patents, it is take it or leave it. You get no “credit” for patent licenses that you already have. The last patent blocks your use of all the others, even if functionally unrelated. (If we had a standard car, the last patent could be on the gas tank while all the others were on the engine or brakes. You wouldn’t follow the car standard unless you follow all of its elements. Each patent embodied in a standard thus effectively blocks all the others.)

What now?

What recourse does the hypothetical newcomer to mumblety peg have?

First of all, enlisting the FTC or Antitrust Division is a nonstarter. They have no interest in revisiting this closed case or reevaluating the significance of the pledges made to gain clearance. They have no interest now in determining whether they bought the Brooklyn Bridge when they issued the clearance.

Moreover, they (or at least their economists) consider that the last patent *should* command the entire price that it does, because that corresponds to the

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marginal value of the last patent to the prospective licensee. Also, they are not interested in getting into haggling over what royalty rate is too high.

Second, there is no IEEE or ANSI to complain to here, even if they would listen in such a case (not too likely). This is a de facto industry standard, not a de jure standard adopted by an institutional committee with attempted due process. The newcomers can complain about their plight to their competitors in the pool, but you can imagine how much effect that would have.

Suits and threats to sue can be considered as another alternative. (Trying to stir up Congress and investigative reporting are more far out options.) A threat to sue is credible only to the extent that an actual suit would be likely to succeed. The main legal theories available in an antitrust lawsuit are that the pool is a combination or conspiracy to monopolize or restrain trade and that the pool agreements are contracts in unreasonable restraint of trade. (This statement however buries the issue of whether it is one pool or the other, or both pools, that the newcomers should be upset about.)

A prospective plaintiff could bring a charge of per se antitrust violation. The hypothetical plaintiff newcomer could allege that the pool members are engaged in one or more conspiracies: price fixing, concerted refusal to deal on individually chosen terms (a boycott), and tie-in licens-

ing of the entire package of patents. The reason for pressing a charge of per se antitrust violation is that the plaintiff in such a case does not need to engage in difficult and expensive proof of actual anti-competitive effects in a relevant market. Also, the plaintiff does not need to address the alleged reasonableness of the defendants’ behavior. Proof that defendants engaged in conduct falling into a per se category, such as price fixing, is all that a plaintiff has to do to establish antitrust liability for resulting damages.

It would be an uphill battle to persuade a court that this conduct properly falls within an established per se category. The kind of price fixing that occurs when patents are pooled is not the same thing that occurs when a group of competitors meets to agree on the price they will charge for an ordinary product. When patents are pooled, there has to be a mechanism for quoting a price to licensees of the pooled patents. Otherwise, there cannot be a pool.

This consideration led the US Supreme Court to rule that royalty price setting by organizations such as ASCAP is not subject to the per se rule against price fixing. Instead, it must be tested under a rule of reason. (Presumably, the same theory would apply to a PC manufactured by a consortium if one company makes the disk drive, another the motherboard, another the power supply, and so on. The PC combination is sold for one price to a buyer. The buyer does not have to negotiate, separately with each OEM for each component.)

Uncertainties

The other theories have more possibilities, but depend on establishing facts that may be difficult to prove. Thus, to show a boycott, the plaintiff would need to prove that the pool members collectively decided not to deal with the plaintiff more favorably than the pool system provided. That means that the plaintiff must show that it is not even plausible that separate, unilateral decisions occurred on how to deal with the plaintiff. The tie-in or

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compulsory package license theory has the best prospects of the per se theories, but it too has difficulties. In effect, the plaintiff would need to prove that it is implausible that the individual licensees who, collectively, did not give the plaintiff better treatment than the pool offered, acted in concert rather than individually in the pursuit of their self-interest.

Still, this is a field in which the law is very much uncharted. The law remains, until the Supreme Court authoritatively resolves the issues, whatever a judge or jury wants to make of it. Therefore, even if a per se theory of antitrust will not carry the day for the hypothetical plaintiff in this case, a jury might well be sustained in finding that the pool or pools acted in unreasonable restraint of trade in any of several ways.

First, the plaintiff might simply maintain that the two pools' cumulative royalty of approximately 8% on an essential facility is too high to permit an entrant to operate at a profit and thus enter the market. Establishing what is too high a price for an essential facility—here, use of patents

covering a standard—is without precedent. It also involves the relationship between the two pools. Concededly, one royalty of about 4% is *not* too high, but twice that much is said to be too high. Which pool is responsible for the fact that the plaintiff must pay approximately 8%? Is there, and can the plaintiff prove, a conspiracy between the two pools? If not, which pool is responsible and why? This is a tough case for the plaintiff to win but perhaps not an impossible one.

A second theory is that the second pool is acting unreasonably in demanding the full 4% when the plaintiff already has a cross-license covering part of that pool. Say that the technical guru allocated half the points for patents to those on which the plaintiff newcomer already has a license. Hence the plaintiff wants a license only on 2% worth of the 4% worth of patents in the pool. That the pool demands the full 4% arguably is unreasonable and close enough to compulsory package licensing to amount to an unreasonable restraint of trade. (Obviously, a tie-in sale can be effected by charging so much for one of the products when bought separately that it is uneconomical to buy the tied products separately.)

A third theory involves a factual variation on the second one. Say that the plaintiff has a cross-license from one or more pool members that accounts for half the weighted value of the pool of patents (2% out of 4%). Two other pool members each have patents amounting to a quarter, that is, each accounting for what the technical guru assigned 1% of the 4% royalty. The plaintiff asks each of them for a license on its patents, and each demands 1.8%. Thus, the two would require 3.6%, which is a slight improvement over 4%, but nothing like the 2% that the plaintiff seeks.

If a conspiracy could be proved, the plaintiff would be in business (the litigation business, that is). But suppose no conspiracy can be proved. Is this kind of discrimination unreasonable? Is it discrimination? Is it relevant that the pool, meaning the combination of all of the defendants, including the two of them demanding 1.8% each for their patents,

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pledged to the government that the pool would not discriminate? How to sort this out is a mystery to me. But certainly it is fair game for litigation.

The uncertainty of how this would sort out, and the risks for a defendant of predicting incorrectly, suggests that a compromise of some sort is the most prudent course. So, playing with the Mumblety Peg Standard turns out to be a poker game that puts a very high premium on maintaining a strong bluff.

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